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ABSTRACT

Given the need for a large stimulus by the federal government in the short-run and given the need for structural reform on our budgeting and taxing process over the long-run, what is likely to happen to federal expenditures for higher education? Two issues likely to arise are: (1) in this next year there is absolutely no excuse for holding back new higher education programs or fuller-funding of old programs because of "inflation"; and (2) if tax cuts are to be used to bring the economy out of the doldrums, the tax changes should be (primarily) temporary ones. During the recovery, the prerequisites for a sensible tax-and-budgeting process should be put in place. How the government decides the big issues of short-term economic stimulus and long-term budget reform more than anything else will determine the fate of federal aid to postsecondary education. (Author/KE)

Robert W. Hartman
Jan. 10, 1975

The Federal Budget Outlook and Its Implications For Higher Education

I start with two famous scriptural quotations:

"It takes a fool to try to predict the federal budget two weeks before it is released" and

"It takes an economist to confuse a simple situation."

My overall plan is to prove that the union of these two sets of characterictics is alive and well at the Mayflower Hotel.

The Federal Budget Outlook

The confusion one senses in the newspapers about fiscal policy is, in a sense, surprising. In contrast to the past few years, there is widespread consensus today on the state of the economy: it is slipping, rapidly. This ought to mean that the required fiscal policy is one of stimulus -- of considerable magnitude, and the sooner the better. And yet within the past month we have had on the table simultaneously proposals for income tax surcharges, multi billion dollar energy tax increases, and proposed budget cuts. Things are beginning to settle down to a discussion of tax reductions, but the range of proposed reductions -- anywhere from $10 to $35 billion -- stagger the mind.

It would be comforting for me to tell you that the range of fiscal policy prescriptions stem from different conceptions of the relative damage done to our society by inflation and unemployment. If that were

the case, I could tell the story in good guy/bad guy terms and we could all rejoice in the fact that we are back to politics as usual, with the liberals on one side and the conservatives the other.

But I am convinced that part of today's debate stems from the fact that there is disagreement over what federal budgetary stance constitutes a stimulus, a depressant or a neutral posture. On this technical issue there is no bad guy/good guy dichotomy but rather the wrong view -- which for the sake of brevity I will call William Simon's position -- and the right view -- which I will now try to explain.

Innumerable speeches and testimonies of the Secretary of the Treasury inexorably focus on the growth in federal expenditures or in the federal deficit as the measure of the stimulation exerted by the federal government on the economy. There are many things wrong with this view but I want to focus on one, which is not widely understood: this is the tendency of the federal individual income tax to automatically increase its drain on real income (and thus real spending power) in times of inflation. Unless this tendency is recognized, it is impossible to understand what is required of the federal government to offset such a drain on demand for goods, services, and ultimately for workers.

In 1973, a typical federal taxpayer might have been earning $15,000. Assuming a joint return with 4 exemptions and a reasonable estimate of deductions,* such a taxpayer would have paid $1,600 in federal taxes. What would have happened to this taxpayer's liability in 1974 had his real income remained fixed? -- thus abstracting from the decline in economy

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* Deductions are assumed to be $3,000.

and focusing on the tax system itself.

With an inflation rate of 11% the taxpayer family's income would have risen to $16,650 (11% by assumption) but his taxes would have gone up to almost $1,900, an increase of about 18 percent.* Part of this increase can properly be treated as an automatic stabilizer -- the built-in feature of the tax system that raises or lowers actual tax liabilities to counter the business cycle. But when one removes this (desirable) cyclical component, and focuses on the increase in <u>real taxes</u> at a constant level of real income, there remains an increase in federal income taxes of about 6.4 percent for the typical taxpayer between 1973 and 1974.** The economic effects of the inflation-induced automatic growth in real taxes at a fixed level of real income is exactly the same as if Congress had voted to impose a tax surcharge -- it depresses demand in the economy and slows down employment.

Moreover, we can expect more of the same in the coming year. Even with inflation ebbing somewhat -- as most forecasters predict -- real tax

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* Assuming that deductions rise by 11 percent, the same rate as income, the tax liability rises to $1,890.40. The implied elasticity of tax liabilities to income is about 1.65. c.f. Pechman, BPEA.

** Expressed in 1974 dollars, the 1973 tax liability of $1,600 becomes $1,776. The 1974 tax liability of $1,890.40 (see last footnote) represents a 6.4 percent increase over $1,776, both measured in 1974 dollars.

rates will probably rise another 5.4 percent.* Thus over the two years covering the calendar years 1974 and 1975, inflation alone has raised personal income taxes in real terms by over 12 percent. With a fiscal year 1975 individual income tax take of about $125 billion, these tax hikes alone account for a drag on the economy of about $15 billion.

Thus, just to offset the backdoor tax personal income tax increases** that will have taken place will require expenditure increases or tax reductions of $15 billion this year.

A federal government that simply offset inflation induced tax increases would not be doing enough in a growing economy. Each year as the labor force grows and its productivity increases,*** the government must spend more (or tax less) lest it exert a drag on aggregate demand. A reasonable estimate of these growth requirements would amount to about

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* This result presumes an increase in the GNP deflator of 9.1 percent in calendar year 1975, as projected in "The 1976 Current Services Budget: A Staff Study," Joint Economic Committee, (mimeo, Dec. 31, 1974), p. 16. To calculate the percent increase in real taxes (r^x) I used the formula

$$1 + r^x = \frac{1 + n\, r_p}{1 + r_p} \quad \text{where}$$

n = elasticity of taxes with respect to income growth (equals 1.65).
r_p = the rate of growth of prices.

** A similar, but much smaller, phenomenon may be occurring in corporate profits taxes, the real yield on which is increased by price-induced inventory capital gains. However, these tax increases can be largely offset by corporations if they switch to the LIFO accounting convention. I do not have the data on which to estimate the net effect of those corporate tax influences.

*** One should not be mislead by recent reductions in productivity, most of which are related to the business cycle -- not to any intrinsic, long-term productivity decline.

10 percent for the two-year period 1974-75 and applied to all federal spending (net of unemployment benefits*) of about $298 billion in fiscal 1975, growth imposes a needed expansion of federal spending or net tax relief of about $30 billion.

Combining the inflation and growth estimates, and converting the result into fiscal 1976 dollars, we are talking here of added federal spending (or tax relief) in the ball park of about $54 billion or a budget total of $362 billion** just to remain neutral, offsetting the drag of inflation and growth in 1974 and 1975. I should further note that I am bending over backwards to be conservative here, not compensating at all for a small social security tax increase in 1975 or for inflation-induced corporate profits rate hikes.

The debate that engages the nation should be over how quickly we ought to be restoring the economy to its desired path -- that is, how much in excess of $360 billion (read how much in excess of a $50 billion deficit) we will need in the coming fiscal year. Instead, all

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* Unemployment benefits in fiscal 1975, are estimated at $6.1 billion from the February budget plus increases of $3.3 billion recently estimated by the JEC, op. cit. The 10 percent estimated is based on real growth of 4 percent per annum and on elasticity of total federal taxes of 1.25.

** Inflation-induced tax increases plus growth requirements amount to $49 billion in fiscal year 1976 dollars. This sum is added to the $298 billion in fiscal year 1975 federal outlays, net of unemployment compensation, and then 14.6 billion of unemployment transfers are added to attain a fiscal 76 total. Thus inflation and growth account for $49 billion of the increase; the remainder is the growth of unemployment compensation. (On the latter see JEC, op.cit.)

signals point to the Administration being so overwhelmed by the budget deficit implications of even a modest stimulative program that we will have too little of it. Congress, meanwhile, has yet to show that the increased powers it has voted itself will result in a coherent attack on the growing weakness in the economy. I suspect that as time marches on, and the unemployment rate marches up, even bond market bankers will realize that the worst thing for them is a populace with declining incomes and declining savings. The deficit bullet will then be bitten, probably too late to make the Bicentennial Year an occasion for celebration.

Spending Boosts or Tax Cuts

Once the decision is made to stimulate the economy, the government will be faced with a choice of expanding through expenditure increases or through tax cuts. [I hope the relation of all this to financing postsecondary education is becoming apparent ....] Although I have emphasized, in my remarks, the depressing effects of inflation on our federal taxes, it would be a mistake to conclude that the cure lies on the tax side. Many economists -- and other conservatives (I chose my words carefully) -- advocate the permanent cleansing of the tax system of the inflation-induced tax increases; this is called indexing. My view is that such a permanent change would be a mistake, and to explain why I have to back up a bit and look at recent budget history.

For the past several years, whenever restraint seems to have been called for, the focus of inflation-fighters has turned to the expenditure side of the budget. Given the fact that certain components of federal outlays could not be controlled in the short-run (entitlement programs, interest on the debt, spending on previously incurred commitments) the axe has fallen -- at least in Presidential proposals -- on a narrow part of the budget. In the domestic area, grants-in-aid and research stand out. Moreover, the focus on expenditure control has made it difficult to start new federal programs -- or fully fund old ones -- because the short-term budget situation has dominated the debate.

These actions have been a failure from nearly every conceivable point of view. They have not held down outlays -- indeed, Congress has taken the opportunity to expand benefits in uncontrollable programs. (Thus making it impossible to start up new programs in the next year.) Most important, however, is the fact that these expenditure control exercises have paid almost no attention to what such exercises should be about: namely, how to set public expenditures consistent with national priorities. Similarly, when Congress recently enacted a public service employment program much attention was paid to how fast expenditures could be made, rather than to the underlying structure of the program.

I have concluded from these recent episodes that the expenditure side of the federal government's activities is the wrong place to regulate the economy's fiscal thermostat. Public priority decisions must be made for the long-run and, inevitably, that will imply that appropriations and outlays must be voted on a multi-year basis.

If federal spending plans were set for several years with long-run priorities in mind, two critical steps would have to be taken in the tax area. First, a system of quickly implementable tax rebates and surcharges would have to be placed on the books so that taxes could serve as the primary federal instrument for boosting or lowering demand. In order for such a system to command wide support federal taxes would have to be recognized as "fair," meaning that "tax reform" -- the elimination of abuses in the tax system -- has to be given high priority. Second, the overall tax level around which these surcharges and rebates would dance, would have to be set so as to be consistent with aggregate spending projections and the need, if any, for long-run public saving to enhance capital growth in the economy. This menu for taxation -- a surcharge and rebate system, tax reform, long-run schedule setting consistent with public service and private capital needs--take precedence over indexing or any other permanent change in taxes.

The Current Dilemma and the Outlook for Higher Education

Given the need for a large stimulus by the federal government in the short-run and given the need for structural reform in our budgeting and taxing process over the long-run, what is likely to happen to federal expenditures for higher education? The short answer is "I don't know," but I think I can give some guidance on issues that are likely to arise.

First, for as long as we continue to operate on federal expenditures one-year-at-a-time. in this next year there is absolutely no excuse for

holding back new higher education programs or fuller-funding of old programs because of "inflation." To the extent that the Basic Educational Opportunity Grant Program or other programs in the 1972 Amendments were held back out of fear of fanning the fires of inflation, the coming year is the time to undo such treatment. I hope the debate over education appropriations is thus turned into a debate on the social merits in the long-run of the various programs authorized by the Congress. I would note, however, that even in the long-run there are indeed budget constraints, so that higher education, under any budget regime, must justify its receipt of funds.

Second, despite the reasoned case I thought I just made for holding off on permanent changes in the tax system, the temptation to do so is going to be very strong in the coming year. It is simply a fact that no one can gin up sensible multi-billion dollar spending programs in say, postsecondary education, that will result in quick employment advances. The lesson here I think is clear. If tax cuts are to be used to bring the economy out of the doldrums, the tax changes should be (primarily) temporary ones. During the recovery, the prerequisites for a sensible tax-and-budgeting process should be put in place.

How the government decides the big issues of short-term economic stimulus and long-term budget reform more than anything else will determine the fate of federal aid to postsecondary education. I can't help closing with another quotation "what's good for higher education is good for the U. S. A. and, in this case, for General Motors, too."